APPLICATION OF

ROANOKE GAS COMPANY **CASE NO. PUE980626**

For general increase in rates and to revise its tariff

REPORT OF MICHAEL D. THOMAS, HEARING EXAMINER

June 29, 1999

HISTORY OF THE CASE

On September 30, 1998, Roanoke Gas Company ("Roanoke" or the "Company") filed an Application for a General Rate Increase (the "Application"). Initially, the Company sought a rate increase of $877,527, which was designed to provide it a 10.7% return on equity. In order to meet safety and service obligations, the Company requested the increase to recover the capital costs associated with replacing its aging distribution system. In addition, the Company proposed several changes to the general terms and provisions of its tariff. These included the addition of a Distribution System Renewal Surcharge ("DSR Surcharge") to recover the annual incremental carrying costs and increased depreciation expense associated with its ongoing distribution system renewal program, a Revenue Stabilization Surcharge to protect against wide fluctuations in revenues and customers' bills associated with extremes in winter weather, and replacing cubic feet based rates with therm based rates.

The Commission entered an Order for Notice and Hearing on October 27, 1998. The Commission docketed the Application and suspended the Company's proposed rates, charges, and tariff revisions for a period of 150 days from the date the Application was filed. As a result, the Company's proposed rate increase was effective for service rendered on and after February 27, 1999, subject to refund with interest. The Commission scheduled a public hearing for April 13, 1999, for the purpose of receiving evidence and public comment relevant to the Company's Application. Finally, the Commission required the Company to publish notice of its proposed rate increase and tariff revisions and make a copy of its Application available for public inspection.

On February 5, 1999, the Company advised the Commission that it would place its interim rates into effect on February 28, 1999. The Company filed an executed bond dated February 3, 1999, in the amount $722,565 to secure any refunds which the Commission may subsequently order.

The Office of the Attorney General, Division of Consumer Counsel ("Consumer Counsel") filed its notice of intent to participate as a party in this proceeding on February 18, 1999.

On February 25, 1999, the Commission entered an Order Consolidating Issue with Rate Case. The issue joined in this proceeding involved the reversal of the redistribution of certain deferred costs associated with the removal of a retired gas manufacturing plant.

The Staff of the State Corporation Commission (the "Staff") filed a Motion for Extension on March 3, 1999. The Staff stated in its motion that the parties were engaged in discussions to settle certain issues in the case and they needed additional time to reach an agreed settlement. The Staff further stated that the parties intended to file a joint stipulation setting forth the agreed upon issues contemporaneous with the filing of the Staff's prefiled testimony.

On March 19, 1999, the Staff filed a Stipulation agreed to by the parties. The parties recommended the Commission adopt, without change or condition, the agreements set forth in the Stipulation. A copy of the Stipulation is attached to this Report as Appendix A. The Stipulation provides that:

1. The Company's prefiled direct testimony of John B. Williamson III, Arthur L. Pendleton, J. David Anderson, and Charles F. Phillips; the prefiled additional direct testimony of Mr. Williamson and Mr. Anderson; and Schedules 1-31 and 33-36 may be accepted into the record without the witnesses present and without cross-examination, except that Mr. Williamson will be available for direct and cross-examination on the issue of the distribution renewal program as contained in the direct testimony of Mr. Pendleton.

2. The prefiled direct testimony and the additional prefiled direct testimony of Company witness Dale P. Moore, and Schedule 32, may be accepted into the record with the witness available for direct and cross-examination on the issue of the DSR Surcharge and the related distribution system renewal program.

3. On March 19, 1999, Staff will submit the prefiled testimony of witnesses Mary E. Owens, John A. Stevens, and Scott C. Armstrong. Staff's prefiled testimony will recommend that Roanoke receive a rate increase designed to recover an additional $433,650 in gross annual revenue based on a return on equity of 10.5%, the midpoint of a 10% to 11% range. Staff's prefiled testimony will also review the Company's proposed DSR Surcharge, but it will not recommend Commission approval or rejection of this Company proposal. The Staff's prefiled testimony may be accepted into the record without cross-examination, except that Staff witnesses will be available for direct and cross-examination on the issue of the DSR Surcharge and the related distribution system renewal program.

4. The Company's request for a Revenue Stabilization Surcharge, Original Sheet No. 154 of Roanoke's Gas Tariff, Original Volume No. 3, is withdrawn.

5. For purposes of establishing the Company's rates in this proceeding, the Staff's recommendations are fair, just, and reasonable, and are accepted as set forth in Staff's prefiled testimony. . . . (The Staff's recommendations and the resulting rates, as later revised in a Supplemental and Amending Stipulation, are set forth in Exhibits 1 and 2 attached hereto.) Those recommendations relating to the proposed DSR Surcharge that are to be included in the Staff's prefiled testimony will be addressed at hearing and are not withdrawn by this Stipulation.

6. Based upon the foregoing stipulations, Roanoke waives its right to file rebuttal testimony on all issues with the exception of the DSR Surcharge.

7. Roanoke's proposal to implement a DSR Surcharge will be fully litigated, and nothing herein is intended to suggest that Staff or Consumer Counsel recommends Commission approval of this surcharge. Nor does the Staff or Consumer Counsel waive their right to address possible statutory or other legal issues related to implementation of the DSR Surcharge. However, if the Company's proposed DSR Surcharge is approved by the Commission, it is stipulated that the Company's proposal and tariff to implement a distribution system renewal surcharge be modified as follows:

    a. Subject to the Conditions set forth in this Stipulation, if the DSR Surcharge is approved, the base non-gas rates which result from this rate proceeding shall remain in effect until November 30, 2002; and the DSR Surcharge shall be limited to an initial three-year period also expiring on November 30, 2002. Further, the DSR Surcharge may be treated as a voluntary rate design experiment subject to the provisions of Va. Code §§ 56-234 and 56-235.4 A (iv).

    b. The amount of each ensuing year's surcharge rate shall be based on the revenue requirement effect of the incremental distribution system renewal investment as of September 30 of the previous fiscal year divided by the projected billing determinants for the twelve-month surcharge period. The revenue requirement shall take into account the depreciation costs based on approved depreciation rates and the carrying costs based on the most recent fiscal year capital structure and the approved return on equity. The depreciation component shall be reduced by depreciation related to plant retired due to the renewal program, and the surcharge may incorporate costs of removal. The methodology for projecting billing determinants shall be consistent with the method used for projecting billing determinants in the Company's PGA and ACA tariffs.

    c. For each fiscal year (October through September) beginning with the fiscal year ended September 2000 through the fiscal year ended September 2002, the Company shall perform and file with the Commission an earnings test, which shall calculate the earned return on equity ("ROE") using the same methodology and comparable adjustments used in the Company's earnings test applicable to regulatory assets. These annual earnings tests shall exclude surcharge revenues by adjustment and shall reflect under- or over-recoveries relative to a 10.25% benchmark ROE.

d. By December 31, 2002, the Company shall file with the Commission a report reflecting the amount of DSR Surcharge revenue collected over the previous three annual surcharge periods. These surcharge collections shall be refundable to the extent they exceed any net underearnings determined in subparagraph 7.c. over the three earnings test periods. Such excess shall be refunded with twelve months' interest to customers based on a refund rate calculated by dividing the net over-collected surcharge by projected billing determinants. The refund rate shall be in effect for a single 12-month period.

e. At the conclusion of the three-year effective period, the DSR Surcharge will terminate. However, if the Company wishes to either seek an additional experimental period or seek to make the surcharge permanent, the Company shall make such filing with the Commission within the context of a rate case application. The timing for such filing may allow for any new rate effective period to coincide with the conclusion of the three-year surcharge period.

f. Pursuant to subparagraph 7.a. above, the base non-gas rates which result from this rate proceeding shall remain in effect until November 30, 2002. However, if circumstances make it necessary for the protection of the legitimate interests of the Company's customers or its shareholders, the parties to this Stipulation recognize that the Commission may, on its own motion, or on the motion of any of the parties to this Stipulation, or any other interested party, institute a proceeding to consider and to order such increases, decreases, or other changes in rates necessary for the protection of those interests. The Staff, Company or any interested party may oppose any such motion or the establishment of any such proceeding.

g. The prohibition on additional Roanoke Gas Company base non-gas rate changes until December 1, 2002 would not prevent the Company from filing for special rates such as a system expansion rate for extension of service into previously unserved areas or for a rate plan designed to conform, in steps, the rates in Bluefield, Virginia, currently the service territory of Commonwealth Public Service Corporation, with the rate structure of Roanoke Gas Company.

8. The Company should be authorized to move to therm billing on October 1, 1999, to coincide with the beginning of a new fiscal period.

9. This Stipulation is not severable, except to the extent that, pursuant to paragraph 7, the agreements under this Stipulation are not conditioned on Commission approval of the DSR Surcharge. In the event the Commission determines not to accept and approve the Stipulation in its entirety, the Participants respectfully request that the Commission issue an interim order remanding the matter to a Hearing Examiner and providing the Participants the opportunity to attempt to

reach a modified stipulation that addresses the Commission's concerns; and, if no such modified stipulation can be reached, the Participants, or any one of them, may withdraw their support for this Stipulation and proceed with further hearing on any of the issues raised in this proceeding.

10. No Participant shall be deemed to have accepted or approved any rate of return, ratemaking or tariff principle, or any method of cost-of-service determination, cost allocation, or rate design, for purposes other than the resolution of the issues addressed in this Stipulation.

The parties filed a Supplemental and Amending Stipulation on April 5, 1999. In this Stipulation, the parties agreed to revise the rates that were attached to their previous Stipulation, as Exhibit 2, Pages 1 and 2, to be consistent with their agreed upon revenue increase of $433,650. A copy of the Supplemental and Amending Stipulation is attached to this Report as Appendix B.

On April 7, 1999, the Company filed a Motion to Implement Rates and Provide Refund. In its Motion, the Company requested that it be given authority to implement the rates contained in Revised Exhibit 2 attached to the Supplemental and Amending Stipulation and to refund to its customers over-collections, with interest, that occurred since it placed its interim rates into effect on February 28, 1999. By Hearing Examiner's Ruling entered on April 8, 1999, the Company's Motion was granted, subject to any future refunds that may, or may not, have to be made when the Commission approves final rates in this case.

At the appointed time on April 13, 1999, this matter came on for hearing. The Company appeared by its counsel, Michael J. Quinan, Esquire. The Commission's Divisions of Energy Regulation and Public Utility Accounting appeared by their counsel Don R. Mueller, Esquire, and C. Meade Browder, Jr., Esquire. The Office of the Attorney General, Division of Consumer Counsel appeared by its counsel, John F. Dudley, Esquire. The Company's proof of notice was received as Exhibit A. No public witnesses appeared at the hearing to testify and no written comments on the Company's proposed rate increase and tariff revisions were received by the Clerk of the Commission. A transcript of the hearing is filed with this Report.

SUMMARY OF THE RECORD

There were 30 contested issues in this case. The parties' Stipulation resolved 29 of those issues. The accounting issues that were stipulated include: (1) BTU normalization adjustment; (2) management fee adjustment; (3) revenue annualization (update of tariff rates based on gas costs, test year volumes rather than BTU normalized volumes); (4) weather normalization (allocation of normalized volumes between rate blocks); (5) payroll; (6) rate case costs; (7) pension expense; (8) medical costs; (9) outsourcing of line location costs; (10) depreciation study costs; (11) meter reading costs; (12) capitalization of $13,802 in reorganization costs; (13) rate base update; (14) reversal and write-off of redistributed costs of removal (issue joined from Abbreviated AIF Case No. PUE970908); (15) deferral of Y2K costs; (16) stipulation of accounting adjustments and incremental additional gross annual revenues; (17) safeguards if the DSR Surcharge is approved by the Commission; (18) calculation of the DSR Surcharge; and (19) revenue requirement of $433,650.

The cost of capital issues that were stipulated include: (1) cost of equity capital (Company's ROE range set at 10.00% - 11.00%, with a midpoint of 10.50%); (2) total cost of capital (9.242%, based on June 30, 1998 capital structure and a 10.50% cost of equity); (3) cost of short-term debt (updated rates to reflect a three-month average of the actual cost of short-term debt for the months of October, November, and December 1998); and (4) use of the Company's June 30, 1998, capital structure.

The rules and rate design issues that were stipulated include: (1) revenue apportionment; (2) customer charges and volumetric rates; (3) conversion from mcf to therm based rates; (4) withdrawal of the Company's revenue stabilization weather adjustment factor; (5) implementation of monthly balancing of transportation volumes; (6) Roanoke Gas Company Gas Tariff, Original Vol. No. 3; and (7) safeguards and methodology if the Commission adopts the DSR Surcharge (the parties did not stipulate to the appropriateness of the DSR Surcharge).

The only remaining issue is whether the Commission should approve, or disapprove, the DSR Surcharge. The parties fully developed the record on this issue.

The Company's first witness was John B. Williamson, III, the president and chief executive officer of the Company. In addition to sponsoring his direct and supplemental direct testimony, and pursuant to the parties' Stipulation, Mr. Williamson was also made available for direct and cross-examination on the issue of the distribution renewal program contained in Arthur L. Pendleton's prefiled direct testimony. Mr. Williamson testified the Company proposed the DSR Surcharge to recover the annual incremental carrying cost and increased depreciation expense associated with the Company's ongoing distribution system renewal program. He testified the surcharge is designed to facilitate the Company's ongoing efforts to improve system safety and reliability while minimizing administrative and legal costs associated with frequent rate cases that would be filed to recover the costs that result from such a program. Mr. Williamson testified the primary factor driving the Company's last five rate cases was investment in plant, and non-revenue generating plant in particular. (Ex. JBW-1, at 8; Tr. at 26).

In 1991, the Company identified 190 miles of cast iron and bare steel pipe and 10,820 bare steel service lines in its distribution system. The Company developed its distribution system renewal program and placed it into effect on December 13, 1993. At this time, the Company committed to a 25-year program to replace the cast iron and bare steel pipe in its distribution system. The Company's distribution system was designed in the late 1800's as a manufactured gas distribution system and was converted to natural gas in the 1950's. From the 1800's to the 1960's the product of choice for gas pipeline construction was cast iron or bare steel pipe. Although cast iron pipe possessed structural integrity, after continued use the pipe could fail. If placed in certain soils, cast iron pipe was prone to corrosion. This corrosion was generally localized in small areas. Additionally, cast iron pipe was joined using a bell and a spigot. One end of the pipe was cast in a bell shape and the other end was straight. As the pipe was laid in the ground, a wick material was used to seal the joint between the two sections of pipe. Manufactured gas contained oils that would lubricate this wick material. After the introduction of natural gas in the 1950's, these oils were no longer present in the gas. The wick material could dry out resulting in a loss of seal at the joint and potential leakage. Finally, cast iron pipe, which is not very flexible, is prone to cracking during winter freeze/thaw cycles or road construction. Bare steel pipe also had its drawbacks. If the pipe was not placed under cathodic protection, it was also susceptible to corrosion failure. The Company plots all of its gas leaks by severity and evaluates its leak history to determine which areas of its distribution system are given replacement priority. By 1997, the Company reported that approximately 155 miles of its 844-mile gas distribution system was comprised of cast iron or bare steel pipe. The Company also reported that it had 7,415 bare steel service lines. (Ex. ALP-2, at 5-7; Tr. at 25, 32).

Since 1993, the Company's annual investment in its distribution system renewal program averaged $995,833. In the last two years, this investment averaged $1,398,795. The Company replaces approximately 700 service lines and 8.4 miles of cast iron and bare steel pipe per year. Over the next five years, the Company proposes to invest an average of $1,235,000 per year on its distribution system renewal program. The future investment is designed to keep the Company on schedule to replace approximately 8 miles of pipe and a corresponding number of services each year. (Ex. ALP-2, at 7-8; JBW-1, Schedule 9, at 4; Tr. at 36).

Mr. Williamson testified the distribution renewal program benefits the customer and the Company. For the customer, the program means more reliable service because the gas can be delivered at higher pressure, with fewer service disruptions, less leakage, and increased system safety. For the Company, the program means increased reliability of its system, less intervention in the day-to-day operation of the system, and a reduction in the potential for accidents that may affect the Company's reputation and financial well-being. He further testified the DSR Surcharge would benefit both the customer and the Company in increased efficiencies in the way the costs for the renewal program are recovered. With the DSR Surcharge, the Company will avoid the administrative and legal costs associated with frequent rate cases that would be filed to recover these capital expenditures. (Tr. at 26).

On cross-examination, Mr. Williamson testified the distribution system renewal program is directed at a series of residential neighborhoods in the older part of Roanoke. The Company extensively monitors leaks and wintertime operational pressure flow in these neighborhoods and uses this data to determine which neighborhoods to renew. The Company does not use a rigid set of standards in making this determination, but rather looks at overall operational performance of the distribution system. If the DSR Surcharge is approved, the Company agreed to provide the Commission a narrative outlining the Company's reasoning behind its decision to renew one neighborhood over another. The Company further agreed to report on an annual basis the number of miles of cast iron and steel pipe it replaces by type, the number of service connections it replaces, and whether or not any of these plant replacements are revenue producing. The Company intends to provide the Commission with computer-generated reports on all work orders associated with the distribution system renewal program, which would be broken down by street and by services installed. The Company also agreed to provide access to the source documents used to generate these reports. Although there are no performance standards built into the Company's proposed tariff in terms of miles of pipe or services to be replaced, the Commission Staff would have at least 60 days to review the Company's DSR Surcharge before it is implemented by the Company. The Company indicated it would not put the surcharge into effect if there were a fundamental difference between the Company and the Staff concerning the amount of the surcharge. The Company's position is Commission intervention in this process would only occur after a motion to intervene is filed by either party. (Tr. at 34, 36, 39, 41, 56, and 83-84).

Mr. Williamson testified the Company uses a combination of contractors and its own crews on distribution system renewal projects. The Company solicits competitive bids every three years from contractors to perform utility work. Currently, the Company has two contractors that are certified and participating in drug screening programs to perform work for the Company. The Company's seasonal workload and new construction projects determine to what extent contractors are utilized on distribution system renewal projects. The Company tends to use its own crews on projects that require some flexibility in planning and execution, and contractors on projects where they can work uninterrupted until the job is completed. The Company performed an analysis of the performance of its crews versus contractor crews as a check on whether the contract and the unit bids appear reasonable, and as a check on the efficiency of its own crews. The Company agreed to provide the Staff access to the internal analysis it performs on contractor bids for distribution system renewal projects. (Tr. at 44-46, 58-59).

Finally, Mr. Williamson testified that the Stipulation contains sufficient safeguards to allay the Staff's fears concerning the DSR Surcharge. The Company agreed to an earnings test methodology that ensures the Company will not over earn. The earnings test establishes a 10.25% return on equity, which is below the 10.50% return on equity stipulated by the parties. In the event over earning occurs, the Stipulation provides for a refund, with interest, to the Company's customers. The Company agreed to restrictions on filing a rate case for new base non-gas rates for the period the experimental DSR Surcharge is in effect. As a result, the Company will have an increased incentive to hold down costs and look for ways to increase operating efficiencies wherever possible. Since the distribution renewal program is focusing on older neighborhoods where there has been little new construction, the Company believes that any incremental increase in gas revenue will be *de minimis*. If a new service is added during the distribution renewal construction process, the cost to run service to the property is a new construction cost and would not be accounted for under the renewal program. Mr. Williamson testified the Company understands the necessity to provide its customers information on the DSR Surcharge and to respond to their questions. The Company intends to include a notice on the customer's bill concerning the DSR Surcharge. Mr. Williamson astutely observed that it makes more sense to include the notice on the bill, since most people promptly discard billing inserts in the trash. In addition, the Company plans to provide additional training to its customer service representatives and extend its call center hours if the surcharge is implemented to respond to customer inquiries. (Ex. JBW-13; Tr. at 49-52, 66-68).

The Company's second witness was Dale P. Moore, director of rates, regulatory affairs, and financial planning for the Company. Ms. Moore testified the purpose of the DSR Surcharge is to permit the Company the opportunity to recover the depreciation and carrying costs on all prudently incurred system renewal costs up to a maximum of $1.5 million in renewal investment each year, without the requirement to file a rate case to recover those costs. In her prefiled direct testimony, Ms. Moore stated, if the Company invested the entire $1.5 million in its distribution renewal program, customers' bills would increase by 0.5%. At the hearing, Ms. Moore testified she developed a methodology for calculating the DSR Surcharge. This methodology was reviewed and subsequently amended by the Staff. Ms. Moore agrees with the Staff's amendments and this agreement is set forth in Exhibit DPM-15. Finally, Ms. Moore testified the Company intends to print a notice on customers' bills advising them of the surcharge, and any increases in the surcharge, and further, the Company will make its annual DSR Surcharge filing available for public inspection. (Ex. DPM-5, at 8-10; Tr. at 75-78, 84-86).

On cross-examination, Ms. Moore was questioned extensively on the issue of "prudently" incurred system renewal costs. She testified the Company would submit information in its annual DSR Surcharge filing to the Staff for their determination whether the system renewal charges should be recovered from its customers. If the Company and the Staff could not reach an agreement on the amount of the surcharge, she confirmed the Company would not implement the surcharge for that period. At the end of the three-year experimental period, the Company is required to have a rate case to determine whether the costs incurred for the renewal program during this period should be incorporated into rate base. Ms. Moore testified interested parties would have an opportunity at this time to question whether or not a renewal cost should be included in rate base. She did concede that the disallowance of a renewal cost would apply prospectively. (Tr. at 79-84).

In responding to questions from the bench, Ms. Moore testified that a residential customer would see a DSR Surcharge of two cents per mcf of gas used. The greater the consumption, the greater the surcharge. A typical residential customer using 10 mcf of gas per month would have a monthly surcharge of $.20. The cumulative effect of the DSR surcharge can be seen in years two and three of the experimental program. In the second year of the program, the same residential customer using 10 mcf of gas per month would be surcharged $.40, and in the third year would be surcharged $.60. A typical small commercial customer using 25 mcf of gas per month would see a surcharge of $2.00 added to their $183.00 monthly gas bill in the first year, and corresponding increases in years two and three. The Company is not proposing to surcharge its interruptible industrial customers. (Tr. at 90-93).

The Staff's first witness was Scott C. Armstrong, a senior public utility accountant with the Commission's Division of Public Utility Accounting. Mr. Armstrong provided an overview of the methodology developed in Exhibit DPM-15 to illustrate the calculation of the DSR Surcharge. He testified the methodology includes the safeguards set forth in paragraph 7 of the parties' Stipulation. However, as with any illustration, he pointed out it contains a number of assumptions that could change when the DSR Surcharge is ultimately implemented. He did testify that the methodology provides a good framework for the ultimate calculation of the surcharge. Mr. Armstrong testified the Staff envisions the Company's DSR Surcharge to be administratively approved or disapproved, and not the subject of litigation year in and year out. He believes the Staff and the Company would be able to reach an agreement on the amount of the surcharge, but if the parties are unable to reach a consensus, they may seek Commission intervention. (Tr. at 99-108).

The parties subsequently stipulated that the methodology set forth in Exhibit DPM-15, as supplemented by the parties' Stipulation, should govern the calculation of the DSR Surcharge. (Tr. at 109).

The Staff's other witness was John A. Stevens, a utilities engineer with the Commission's Division of Energy Regulation. Mr. Stevens first clarified the difference between his calculation of the DSR Surcharge for typical residential and business customers, and Ms. Moore's testimony at the hearing on the same subject. Apparently, in her prefiled direct testimony, Ms. Moore used a factor of 0.5% of total adjusted revenues to compute the surcharge. Mr. Stevens relied on this figure when he prepared his testimony and his illustrations. At the hearing, Ms. Moore relied on Exhibit DPM-15, which uses a factor of 0.32%, to illustrate the impact of the DSR Surcharge on a typical residential customer. Exhibit DPM-15 contains two primary differences over her earlier prefiled direct testimony. First, it includes the safeguards set forth in the parties' Stipulation. Second, it uses the Company's budgeted distribution renewal charges of $1.3 million rather than the $1.5 million cap for distribution renewal charges. Both of these changes have the effect of reducing the surcharge factor. This accounts for the difference between Mr. Stevens' surcharge of $.36 for a typical residential customer who uses 10 mcf of gas per month, and Ms. Moore's surcharge of $.20 for the same customer.[1] (Ex. JAS-12, at 20; Tr. 111-15).

Mr. Stevens' testimony further provides a summary of the advantages and disadvantages of the DSR Surcharge. According to Mr. Stevens, the primary benefit of the surcharge is the time and expense the Company will avoid in regulatory proceedings. In addition, he stated the surcharge will: (1) provide the Company an incentive to replace its cast iron and steel pipe, thereby improving system safety; (2) stabilize the Company's rate of return making it easier to attract capital; and (3) ease the effects of "regulatory lag." On the disadvantage side, Mr. Stevens stated: (1) the surcharge ignores offsetting savings in other areas, such as improved operating efficiencies, that would have the effect of reducing rates; (2) the surcharge ignores earnings that may be generated by new growth along the renewed system; (3) management no longer has an incentive to engage in hard bargaining in construction contract negotiations; (4) the surcharge removes one of the Company's risks of doing business; and (5) there is no opportunity for public scrutiny of the costs that make up the surcharge. (Ex. JAS-12, at 21-22; Tr. at 115-120).

Mr. Stevens testified the DSR Surcharge does not meet the requirements set forth by the Commission in Application of Old Dominion Power Company, Inc., Case No. PUE830035, 1984 S.C.C. Ann. Rep. 408, 409 (Opinion, June 11, 1984) for an automatic adjustment clause. For this reason, the proposed DSR Surcharge is being treated as a voluntary rate experiment subject to an annual earnings test. Unlike automatic adjustment clauses, the DSR Surcharge is intended to provide the Company an incentive to make non-revenue producing investments to improve operational safety of the Company's distribution system. Mr. Stevens testified the Staff's review of the DSR Surcharge would be similar to its review of automatic adjustment clauses. In both instances, they would be reviewing similar information. (Ex. JAS-12, at 22-23; Tr. at 117).

Finally, on cross-examination, Mr. Stevens testified the DSR Surcharge would be apportioned among the Company's residential and commercial customers and not the Company's interruptible industrial customers. The Company intends to apportion the DSR Surcharge in the same manner as the revenue increase requested in the parties' Stipulation. A cost of service study conducted by the Company indicates interruptible customers are providing a return far in excess of the system's return and the return on residential customers. Over the Company's last three rate cases, the Company has apportioned its rate increases based on the Company's cost of service for each customer class. Mr. Stevens testified that, for at least the next three years, the Company's distribution renewal program would focus on mostly residential areas with small commercial pockets. (Tr. at 126-32).

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[1]The 0.32% factor represents the best estimate of the DSR Surcharge that would be paid by the Company's customers. The 0.5% factor represents the maximum surcharge that could possibly be imposed under the DSR Surcharge voluntary rate design experiment.

Consumer Counsel did not sponsor any witnesses. Their case was developed through extensive cross-examination of the other parties' witnesses. Post-hearing briefs were filed by all of the parties.

DISCUSSION

This case presents three issues for Commission consideration. First, whether the rates stipulated to by the parties are reasonable. Second, whether a voluntary rate design experiment, such as the DSR Surcharge, is permitted under Virginia law. Finally, whether the Commission should approve, or disapprove, the Company's DSR Surcharge voluntary rate design experiment as set forth in the parties' Stipulation.

The parties stipulated the Company should receive a rate increase designed to recover an additional $433,650 in additional gross annual revenue based on a return on equity of 10.5%. This amount is significantly less than the $877,527 initially proposed by the Company in its Application. The parties further stipulated that, for purposes of establishing rates in this proceeding, the Staff's recommendations are fair, just and reasonable.

The legal standard for gas company rates is set forth in Section 56-234 of the Code of Virginia. The statute provides, in part, that:

> It shall be the duty of every public utility to furnish reasonably adequate service and facilities at reasonable and just rates to any person, firm or corporation along its lines desiring same. It shall be their duty to charge uniformly therefor all persons, corporations or municipal corporations using such service under like conditions. . . . The charge for such service shall be at the lowest rate applicable for such service in accordance with schedules filed with the Commission pursuant to § 56-236.

The record in this proceeding supports a finding that the final rates set forth in the parties' Supplemental and Amending Stipulation are reasonable. The parties' Stipulation incorporates a number of accounting and cost of capital adjustments, which effectively reduced the Company's requested rate increase by over 50%. The resulting final rates appear to be fair, reasonable, and not unfairly discriminatory. There is no evidence in the record to the contrary.

The parties proposed that the Commission treat the Company's DSR Surcharge as a voluntary rate design experiment. In its testimony, the Staff observed that the DSR Surcharge does not meet the criteria for an automatic adjustment clause. (Ex. JAS-12, at 22-23). In Application of Old Dominion Power Company, Inc., Case No. PUE830035, 1984 S.C.C. Ann. Rep. 408, the Commission set forth the requirements for automatic adjustment clauses. In that case, the Commission opined:

> the purpose of an automatic adjustment clause is to allow a utility to adjust, without a rate proceeding, its revenues in response to changes in the cost of relatively volatile,

major expense item which the utility incurs on a continuous basis and over which it has little control.

Id. at 409.

As Staff witness Stevens testified, the costs associated with the DSR Surcharge are not volatile and they are within the control of the Company. Recognizing these differences, the parties advocate that the Commission consider the DSR Surcharge a voluntary rate design experiment. (Ex. JAS-12, at 22-23).

Section 56-234 of the Code of Virginia permits voluntary rate design experiments.[2] The statue provides, in relevant part, that:

> no provision of law shall be deemed to preclude voluntary rate or rate design tests or experiments, or other experiments involving the use of special rates, where such experiments have been approved by order of the Commission after notice and hearing and a finding that such experiments are necessary in order to acquire information which is or may be in furtherance of the public interest.

The record in this proceeding supports a finding that the Company's distribution renewal program is in the public interest. Although the Company had already committed to a 25-year distribution system renewal program, the DSR Surcharge encourages the Company to continue this program to improve the overall safety and reliability of its gas distribution system. The real question is whether the DSR Surcharge will achieve the economic gains for the Company and its customers in avoided rate case expenses and improved operational efficiency of the Company. This question can only be answered in three years after an in-depth analysis of all the data from the experiment. Hence, there is a need to proceed with the DSR Surcharge as a voluntary rate design experiment to determine whether these efficiencies are real or illusory.

Although it operates in both regulated and non-regulated markets, the Company proposed the DSR Surcharge as an innovative solution to recovering all prudently incurred investments in non-revenue generating distribution system improvements. Many proponents of competition assert that competition drives innovation. However, in this instance a small regulated gas company is willing to try something new and different because it believes that it is the right thing to do for the Company and its customers. Staff witness Stevens testified he was unaware of any similar program in the United States. (Tr. at 125). There is no doubt that the Company's aging cast iron and bare steel distribution system needs to be replaced to ensure the Company's distribution system complies with state and federal gas pipeline safety requirements. The solution proposed by the Company allows it to recover these costs outside of a traditional rate case, albeit still under the regulatory oversight of the Commission. The Staff and Consumer Counsel neither supported, nor opposed, the Company's proposed DSR Surcharge. However, they did recommend that certain safeguards be placed into effect if the Commission approves such surcharge, and they did raise several concerns with the surcharge in their post-hearing briefs.

[2]Section 56-235.4 A (iv) of the Code of Virginia exempts experimental rates established pursuant to § 56-234 from the statutory prohibition of increasing operating revenues more than once in any 12-month period.

The Staff addressed two points in its post-hearing brief warranting further discussion. The first involves annual reporting requirements. The Staff believes that the Company will provide sufficient information in its annual DSR Surcharge filing for the Staff to calculate the surcharge using the methodology stipulated to in Exhibit DPM-15. This information will permit the Staff, with minimal effort, to determine whether the distribution renewal expenses claimed by the Company are properly recoverable from the Company's customers. The Staff will have access to the Company's distribution system renewal plans, construction bids, the Company's construction bid analysis, distribution system renewal work orders, computer summaries of the work orders, reports on the actual number of miles of pipe and services replaced, and the work papers supporting the Company's DSR Surcharge request. The Staff believes, and I agree, that this is certainly enough information for the Staff to perform an adequate regulatory review of the Company's annual surcharge request. The second point raised by the Staff was revenue-generating replacements, or what happens when the cast iron and steel pipe is replaced and a new customer connects to the new gas main. Mr. Williamson testified that the cost for connecting that new customer is done on a separate work order from renewal projects, is accounted for differently, and would not be included in the DSR Surcharge. (Tr. at 39). As to any incremental increase in revenues, Mr. Williamson testified the Company would calculate a cost for it, and exclude it from the DSR Surcharge. (*Id.*). These actions by the Company should further ensure that the DSR Surcharge is revenue neutral.

In its post-hearing brief, Consumer Counsel voiced three concerns with the DSR Surcharge. First, the DSR Surcharge results in diminished opportunity for public review and comment prior to increases in the surcharge. While the Company indicated that it will make its annual DSR Surcharge filing open for public inspection, Consumer Counsel is concerned that the public has no input into the process of determining the annual surcharge. The public received adequate notice of this proceeding and had an opportunity to participate, but chose not to. No public witnesses appeared at the hearing and no public witnesses filed any written comments to the Company's proposed Application. No doubt, there may be some public comment when the surcharge appears on their gas bills. If the Commission approves the DSR Surcharge rate design experiment, the Commission would, by its action, establish a ceiling surcharge under which the Company is relatively free to operate during the three-year experimental period. The parties' Stipulation establishes a maximum expenditure of $1.5 million per year for distribution system renewal projects. The testimony in the record indicates that a typical residential customer may expect a surcharge of approximately $.20 per month, if the Company continues its current trend of spending $1.3 million per year in distribution renewal projects, but the surcharge may go as high as $.36 per month, if the Company spends the entire $1.5 million. The surcharge ceiling eliminates the requirement for direct Commission involvement in establishing the surcharge amount on an annual basis. This function may be done administratively by the Company and the Staff using the methodology set forth in Exhibit DPM-15. If the parties are unable to come to a consensus on the amount of the surcharge, the Commission's Rules of Practice and Procedure permit an informal resolution of this dispute. *See*, Rule 5:4 of the Commission's Rules of Practice and Procedure.

Secondly, Consumer Counsel shared the same concern as the Staff that the surcharge may lead to an over-recovery of reasonably incurred costs. Consumer Counsel is concerned that the Company's approach to recovering distribution system renewal expenses may be exploited by other companies in the future. As discussed previously, the additional information provided by the Company in its DSR Surcharge filing would enable the Staff, or Consumer Counsel, to adequately review the requested surcharge. If other companies request a similar surcharge, the Commission, as the case or the public interest may dictate, may or may not require additional safeguards to prevent this from occurring. Unlike Consumer Counsel and the Staff, I believe the DSR Surcharge will force the Company to more closely scrutinize operational expenses and practices to determine where efficiencies may be gained. With the safeguards set forth in the Stipulation, the DSR Surcharge is designed to be revenue neutral. However, the Company is still required to meet the earnings expectations of its shareholders, which in this case has been set at 10.25%.

Finally, Consumer Counsel believes the DSR Surcharge may be inequitable to small residential and commercial customers due to the cumulative impact of the surcharge and inappropriate rate design as it relates to the allocation of the surcharge. The cumulative impact of the surcharge is best illustrated below. The DSR Surcharge amounts were calculated using the data found in Exhibit JAS-12, Attachment 8, and the .5 and .32 factors previously discussed.

Rate Class	Typical Usage	Monthly Gas Bill	Monthly Surcharge Year 1	Year 2	Year 3
Residential	10mcf	$71.59	$.36	$.72	$1.08
Commercial GS-1	25mcf	$183.35	$.92	$1.84	$2.76
Commercial GS-2	100mcf	$641.67	$3.21	$6.42	$9.63

(Assumes: $1.5 million in annual distribution renewal costs)

Rate Class	Typical Usage	Monthly Gas Bill	Monthly Surcharge Year 1	Year 2	Year 3
Residential	10mcf	$71.59	$.23	$.46	$.69
Commercial GS-1	25mcf	$183.35	$.59	$1.18	$1.77
Commercial GS-2	100mcf	$641.67	$2.05	$4.10	$6.15

(Assumes: $1.3 million in annual distribution renewal costs)

Certain of the Company's customers, especially those on fixed incomes, may consider the DSR Surcharge more than a *de minimis* charge. In year three of the program, assuming the Company's budgeted distribution renewal costs, a residential customer would pay a DSR Surcharge of $.69 per month, or slightly more than the current cost of two postage stamps. The Company's customers can take some comfort in the fact the surcharge is not going into some government coffer never to be seen again, as is the case with utility taxes, right-of-way fees, or other utility bill additions, but rather into tangible pipe in the ground in their community that will improve the safety and reliability of their gas service.

Consumer Counsel opposes the Company's surcharge allocation methodology. The Company intends to allocate the DSR Surcharge among its residential and commercial classes in the same manner as its requested rate increase. The Company has not proposed to increase the rates of its interruptible industrial customers. The Company has allocated its most recent rate increases among its customer classes so those classes' rates bear some relation to the cost of service for that class. There are two compelling reasons to agree with the Company's surcharge allocation methodology. First, the areas slated for renewal in the next three years are primarily older residential neighborhoods with some small commercial businesses. Secondly, the Company performed a cost of service study that indicates interruptible industrial customers are providing a return far in excess of the system's return and the return on residential customers. It may be inferred from this study that interruptible customers have been subsidizing residential and commercial class rates for years, a point not raised by Consumer Counsel in its brief. At least for the period of this experiment, the Company's DSR Surcharge allocation methodology appears reasonable. In the future, additional data may compel a different methodology for allocating the surcharge.

This case is a good example where divergent stakeholders are able to negotiate and compromise a substantial number of issues in a general rate case to the benefit of all parties. Through the hard work of the Company, the Staff and Consumer Counsel, the Commission is presented with a DSR Surcharge voluntary rate design experiment with sufficient safeguards built in to protect the interests of the Company's customers. Although the surcharge is probably not perfect in the eyes of all of the parties, it does represent the parties' best efforts at developing a rate design experiment that balances the needs of the Company and its customers. The ultimate goals of the surcharge are to improve the safety and reliability of the Company's distribution system, improve operating efficiency by avoiding certain rate case expenses, and allow management to focus its efforts on operating the Company more efficiently. For these reasons, I am recommending that the Commission approve the Company's DSR Surcharge voluntary rate design experiment.

FINDINGS AND RECOMMENDATIONS

Based on the evidence received in this case, and for the reasons set forth above, I find that:

(1) The Company's final rates set forth in the parties' Supplemental and Amending Stipulation are fair, reasonable, and not unfairly discriminatory;

(2) The Company's DSR Surcharge voluntary rate design experiment is in the public interest; and

(3) The Company's proposed tariff revisions are reasonable.

I therefore ***RECOMMEND*** that the Commission enter an order that:

(1) ***ADOPTS*** the findings contained in this Report;

(2) ***APPROVES*** the Company's proposed increase in gross annual revenues and rates as set forth in the parties' Stipulation, and their Supplemental and Amending Stipulation;

(3) ***APPROVES*** the Company's DSR Surcharge voluntary rate design experiment as set forth in the parties' Stipulation, and their Supplemental and Amending Stipulation;

(4) ***APPROVES*** the Company's tariff revisions as set forth in the parties' Stipulation, and their Supplemental and Amending Stipulation;

(5) ***REQUIRES*** the Company to file an affidavit certifying that all over-collections during the period interim rates were in effect have been refunded; and

(6) ***DISMISSES*** this case from the Commission's docket of active cases.

COMMENTS

The parties are advised that any comments (Section 12.1-31 of the Code of Virginia and Commission Rule 5:16(e)) to this Report must be filed with the Clerk of the Commission in writing, in an original and fifteen (15) copies, within twenty-one (21) days from the date hereof. The mailing address to which any such filing must be sent is Document Control Center, P.O. Box 2118, Richmond, Virginia 23218. Any party filing such comments shall attach a certificate to the foot of such document certifying that copies have been mailed or delivered to all counsel of record and any such party not represented by counsel.

Respectfully submitted,

____
Michael D. Thomas
Hearing Examiner